Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

KEVIN LEE OTTO,

Petitioner,

v.

THE SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Due Process Clause of the Fifth Amendment protects natural persons in disciplinary proceedings against them by the National Association of Securities Dealers, Inc. (NASD) when the penalty imposed includes a lifetime bar from associating with other NASD members.

2. If so, whether the NASD disciplinary proceedings against petitioner Otto violated the requirements of the Due Process Clause.

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PETITION FOR WRIT OF CERTIORARI

Kevin Lee Otto respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on June 12, 2001.

OPINION BELOW

The opinion of the United States Court of Appeals is reported at 253 F.3d 960 (7th Cir. 2001) and appears herein as Appendix A.

JURISDICTION

The United States Court of Appeals for the Seventh Circuit entered its judgment on June 12, 2001. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Amendment V to the U.S. Constitution provides in pertinent part, "No person shall . . . be deprived of life, liberty, or property, without due process of law. . . . "

Title 15 U.S.C. § 78o-3(h). See Appendix D for full text.

STATEMENT OF THE CASE

In 1992, petitioner Otto was a licensed security broker registered with the National Association of Securities Dealers (NASD). (SEC 6). (All record references herein are to record before the Securities and Exchange Commission in No. 00-3897. A certified listing of this record is found at the beginning of the appendix to petitioner's brief in the court below.) He solicited funds from one of his customers for something called "Wisconsin Business Consortium." (SEC 3, Vol I at 95-98). In a letter to this customer, Otto described this "Consortium" as a network of people that shared business "opportunities that you and I as individuals probably wouldn't see . . . " (SEC 27). He told the customer this network "is not an investment nor is it offered by any securities company. It has nothing to do with me as a broker or my brokerage firm. This is a private thing. *** Liquidity depends on what the funds are in." *Id.*

The customer gave Otto $22,000. (SEC 16, Transcript at 56). But the "Consortium" didn't exist. (SEC 16, Transcript at 96). It was just an identifier for this customer's funds. *Id.*, (SEC 3, Vol I at 95-97). Otto deposited part of the money to the account of PowerSource Battery Corporation. (SEC 16, Transcript at 53-56). He held a 49% share of that corporation. *Id.* The rest was given to Otto in a check made out to him. (SEC 3, Vol I at 105). The state securities regulators found this transaction was "authorized" by the customer. (SEC 30 at 3, ¶3).

Otto spent all the customer's money either on the business expenses of PowerSource, which went bankrupt

(SEC 16, Transcript at 90-92), or on his own personal expenses. (SEC 3, Vol I at 100-102).

After the customer began requesting return of the money, Otto eventually deposited checks for $3,576.24 in June, 1994 (SEC 3, Vol I at 104-110) and for $26,346.23 in October, 1994 to the customer's account. (SEC 16, Transcript at 132-133).

On March 14, 1997, NASD filed a complaint against Otto. 253 F.3d at 963. After a hearing before the Regional District Business Conduct Committee, it was found Otto had violated Conduct Rule 2110 requiring members to "observe high standards of commercial honor and just and equitable principles of trade." *Id.* This Committee imposed penalties including a permanent bar from associating with any NASD member. *Id.*

On appeal to the National Adjudicatory Council (NAC) of NASD, Otto argued, *inter alia*, he was prejudiced by the delay in the filing of the NASD complaint because two witnesses had died and the memory of another had faded. See NAC Decision at 8-12 (found in appendix to petitioner's brief in the court below). He further argued he was prejudiced since the customer never testified at the hearing. *Id.* The NAC rejected these claims, finding, *inter alia*, NASD was not a state actor. *Id.* It affirmed the penalty of a permanent bar from associating with any NASD member. 253 F.3d at 963.

Otto appealed to the Securities and Exchange Commission, renewing his constitutional claims. App. 22-27 (SEC Decision). The Commission rejected his constitutional claims, finding, *inter alia*, NASD is not subject to the due process requirements of the Constitution. App.

24, n. 11. The Commission sustained the permanent bar from associating with any NASD member. 253 F.3d at 963.

Finally, Otto appealed to the U.S. Court of Appeals for the Seventh Circuit. App. A (opinion below). That court refused to decide his constitutional claims, holding his admissions "doom his due process arguments." 253 F.3d at 965 & App. 10.

REASON FOR GRANTING THE WRIT

I. The Conflict in the Circuits over whether Self-Regulatory Organizations are State Actors is Ripe for Resolution by the Court.

With the passage of the Maloney Act, 52 Stat. 1070, in 1938, Congress made clear its intent that self-regulatory organization (SRO's) such as registered national securities associations should engage in "cooperative regulation" of the securities business along with the Securities and Exchange Commission. 6 Loss & Seligman, *Securities Regulation* at 2789 (3rd ed. 1990) (quoting Sen. Maloney). So national securities associations were delegated the power to enforce the federal securities laws. See 15 U.S.C. § 78o-3(b)(2). And see Note, *Governmental Action and the National Association of Securities Dealers*, 47 Fordham Law Review 585, 595 (March 1979) (pointing out the word "delegated" has been used by both the House and the SEC).

Since 1938, the NASD is the only national securities association ever to qualify for registration under the Maloney Act. 6 *Securities Regulation*, *supra*, at 2795 & n. 21. In 1983, Congress amended the Act to make it unlawful to

trade in a security unless the trader is a member of a national securities association or an exchange. *Id.* at 2815-2816. This action gave the NASD, for all practical purposes, a monopoly in the over-the-counter market. Furthermore, it is now held NASD has absolute immunity from suit against its disciplinary actions. See, e.g., *Partnership Exchange Securities Co. v. NASD*, 196 F.3d 606 (9th Cir. 1999).

This court has spoken only once on the subject of discipline by self-regulating organizations, finding in *Silver v. NYSE*, 373 U.S. 341 (1963) that the New York Stock Exchange exceeded its statutory authority by sanctioning non-members without notice or a hearing.

Whether petitioner was entitled to the protections of the Due Process Clause in NASD disciplinary proceedings depends on whether NASD is a state actor when it disciplines its members. This Court's decisions on State action "have not been a model of consistency." *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 632 (1991) (dis. opn. per O'Connor, J.). So it should not be surprising that lower federal court decisions conflict on the issue of whether self-regulatory organizations are state actors. One line of cases, exemplified by *Desiderio v. NASD*, 191 F.3d 198, 206-207 (2d Cir. 1999) finds they are not and the conflicting line of cases, exemplified by *Intercontinental Industrial, Inc. v. American Stock Exchange*, 452 F.2d 935, 941 (5th Cir. 1971) finds they are. See Stone & Perino, *Not Just a Private Club: Self Regulating Organizations as State Actors When Enforcing Federal Law*, 1995 Colum. Bus. L. Rev. 453, 486-492 (citing and discussing the contrasting cases).

This conflict has existed for over 20 years, *Note*, 47 Fordham L. R. at 592-593 (discussing earliest cases), and with NASD discipline on the rise, Callery & Wright, *NASD Disciplinary Proceedings – Recent Developments*, 48 Bus. Lawyer 791 (May 1993), it is likely to intensify. Here, a case where a dealer has been permanently deprived of his livelihood without the protection of the Due Process Clause, is a good opportunity for the Court to speak for the first time on this issue and perhaps clarify its state action jurisprudence as well.

CONCLUSION

Counsel respectfully submits the foregoing demonstrates the petition for a writ of certiorari should be granted.

Dated: September 6, 2001

Respectfully submitted,

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Counsel of Record for Petitioner

APPENDIX A

United States Court of Appeals,
Seventh Circuit.

Kevin Lee OTTO, Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, Respondent.

No. 00-3897.

Argued April 17, 2001.

Decided June 12, 2001.

James A. Bolt (argued), New Berlin, WI, for petitioner.

Randall W. Quinn (argued), Susan Strauss, Securities & Exchange Commission, Office of the General Counsel, Washington, DC, for respondent.

Before FAIRCHILD, CUDAHY, and COFFEY, Circuit Judges.

COFFEY, Circuit Judge.

On September 15, 2000, the Securities and Exchange Commission ("SEC" or "Commission") issued an order pursuant to the Securities Exchange Act of 1934, 15 U.S.C. § 78s(d)(1), affirming disciplinary action taken by the National Association of Securities Dealers, Inc. ("NASD") against Kevin Otto. Otto, a securities salesman associated with an NASD member firm at the time of the misconduct charged, seeks review of the SEC order pursuant to 15

U.S.C. § 78y(a)(1). We deny Otto's petition and affirm the SEC's order.

I. Factual Background

During all times relevant to the disposition of this case, Kevin Otto worked as a general securities representative for various NASD member firms including Hamilton Investments, Inc., Wellington Investment Services Corporation, and First Montauk Securities Corporation. Mary Sue Smith[1] became a client of Otto's beginning in 1988 or 1989 and followed him through his various firm transfers.

In February 1992, Otto solicited $22,000 from Smith for an investment in the Wisconsin Business Club ("WBC"). In a letter to Smith Otto explained that:

> WBC is a group of people that network to bring to the table business opportunities which enable me to make some cash. These are opportunities that you and I as individuals probably wouldn't see. . . . Again as I stated on the phone this is not an investment nor is it offered by any securities company. It has nothing to do with me as a broker or my brokerage firm. This is a private thing. It is kind of fun. I think you'll like it. . . . Liquidity depends on what the funds are in.

Otto further professed that the return was reported as a Treasury Bill rate "plus a couple of percentage points."

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[1] During the course of events that gave rise to this appeal, Smith changed her name to Mary Sue Laskowski. For convenience sake, we refer to her throughout this opinion as "Smith."

Smith provided Otto with the $22,000; unbeknownst to her, WBC did not exist.

Rather than invest the $22,000 into WBC as he had suggested he would, Otto instead placed the $22,000 partly in his personal bank account and partly in a Charles Schwab account for PowerSource Battery Corporation, an unprofitable company that he owned and operated with a partner, Donna LeBrecht. Otto used Smith's funds for "personal stuff," business expenses related to the operation of PowerSource, and expenses related to the investigation of other business opportunities. Despite the illicit infusion of capital, PowerSource filed for bankruptcy protection in March of 1992.

To cover up his misuse of her funds, Otto prepared and sent to Smith fictitious portfolio updates that falsely reflected a WBC balance. In April 1994, Smith requested funds from her WBC account. Because he could not immediately return Smith's money, Otto stalled the repayment with more deceit, explaining in a letter that "the invest[ment] club has invested cash. May take a few weeks to find a replacement for your position. . . . Once we sell your seat, we are out unless another opens up." In May, he wrote to Smith that her account's value was $28,576.24 and he had arranged for "all dividends and/or capital gains to date" to be forwarded to Smith. Otto further explained to her that it could take a few weeks to liquidate, and suggested that she withdraw approximately $3,000 immediately, leaving $25,000 in the club to remain active, thus attempting to prolong the charade that he had invested Smith's money in WBC. Smith signed an authorization agreeing to leave $25,000 in the fictitious club, and received a personal check form Otto in

the amount of $3,576.24 in June 1994. Initially the check was returned for insufficient funds, but later Smith was able to deposit it.

Because of the two-month delay between her request and her receipt of the WBC funds, Smith decided to withdraw all of the WBC funds. Still, Otto did not immediately return Smith's money. In a letter dated July 27, 1994, he continued to represent that WBC existed as a legitimate investment club and blamed the delay in receiving her money on the investment club.

> I've not yet received our exit papers for the investment club. As your request is unusual things don't happen that fast. The group has assured me that funds will not be less than its value at the time the funds were requested. . . . This is an exclusive club with most people of professional investment background. I pushed to get us in, therefore I can't cause a lot [sic] wave[s]. I should hope to receive our exit papers soon and subsequently the funds.

Otto finally sent Smith a check for $26,346 (the fictitious balance of Smith's WBC account) on October 22, 1994, approximately six months after her initial request to withdraw her funds.

In October 1994, Smith sent to Otto's then-employer, First Montauk Securities Corporation, copies of records and letters Otto had sent her regarding her WBC account. Nearly thirty months later, on March 14, 1997, NASD filed a complaint against Otto, charging him with violating Conduct Rule 2110, which requires members to "observe high standards of commercial honor and just

and equitable principles of trade." At a subsequent hearing before the NASD Regional District Business Conduct Committee ("DBCC"), Otto admitted that WBC did not exist as anything other than an "insignia." Otto claimed, however, that Smith had authorized him to use the funds as he did. According to Otto, Smith faced marital difficulties and wanted to use WBC in order to hide the money from her then-husband. Otto further claimed that the only reason Smith made a complaint against Otto was because of the request of her father, also one of Otto's clients, who was upset with Otto's handling of his account. Smith's complaint was admitted into evidence at the hearings, but she did not testify. On August 7, 1998, the DBCC found that Otto violated Conduct Rule 2110 and imposed a penalty composed of a censure, a permanent bar from associating with any NASD member, a fine of $110,000, and an assessment of costs in the amount of $3,110.75.

Otto appealed the DBCC's decision to the National Adjudicatory Counsel ("NAC") for NASD. At the hearing before the NAC, Otto again admitted that WBC never existed and that he used Smith's funds for his business and personal expenses. Again Smith did not testify. The NAC found that "Otto's misuse of [Smith's] funds was inexcusable. His misconduct, coupled with his total refusal to acknowledge that he had misused his client's funds by using her money for his own personal and business benefit, makes him a danger to the investing public." Further, in its decision, the NAC explained that even though the guidelines did not recommend a bar for Otto's conduct, it considered a bar "essential based on the egregious nature of Otto's conduct." In support, it noted

three aggravating factors: 1) the series of lies and deception beginning with his solicitation of Smith's funds and continuing throughout her attempts to withdraw her funds; 2) his failure to accept responsibility for his misuse of Smith's funds; and 3) his attempt to lay blame on others, specifically upon Smith herself with his theory that she attempted to use WBC to hide the money in a marital dispute. Accordingly, on June 28, 1999, the NAC affirmed the censure and bar, but reduced the fine to $35,000 because it concluded that the DBCC used a 'conversion" sentencing guideline rather than an "improper use of funds" guideline.

Otto appealed the decision of the NAC to the SEC, which reviewed his case *de novo*. On September 15, 2000, the SEC sustained the censure, bar, $35,000 fine and costs. The SEC found that Otto "deceived his client with a network of lies." The SEC pointed out that, by his own admission, the investment club into which Otto told Smith he had placed her funds did not exist. The SEC further found that when Smith sought to get her money back, Otto repeatedly delayed returning her money and continued the fiction of the investment club, failing to tell Smith that he used her money for his own benefit. The SEC found that Otto's admittedly false statements to Smith demonstrated "deception of a client about the use of money [that] is unethical and reprehensible." In addition, the SEC rejected Otto's procedural objections, finding that the NASD proceedings were fair, noting that Otto admitted "all of the facts necessary to determine his guilt." Finally the SEC held that the sanctions imposed by the NASD were not excessive or oppressive, concluding

that Otto's conduct "demonstrates a serious misunderstanding of the obligations he owes to a customer as a registered representative." Otto now appeals.

II. Issues

Otto raises two issues in his appeal. First, he contends that the NASD proceedings violated his due process rights because hearsay evidence was admitted and relied upon, because he did not have the opportunity to cross-examine Smith, and because the length of time that passed between the misconduct and the hearings deprived Otto of the opportunity to present witnesses on his behalf who had died during the delay. Second, Otto argues that the SEC abused its discretion in sustaining the NASD sanctions that exceeded the recommended sanctions under the NASD guidelines.

III. Analysis

The SEC is the federal agency charged with the regulation of the securities industry, but because the SEC lacks the resources to police the entire securities industry, it relies on participants in the markets to govern themselves. *See Gold v. SEC*, 48 F.3d 987, 990 (7th Cir.1995); *Mister Discount Stockbrokers, Inc. v. SEC*, 768 F.2d 875, 876 (7th Cir.1985). The NASD is a registered association of securities broker-dealers registered with the SEC pursuant to 15 U.S.C. § 78o-3(a) and empowered to enforce association members' compliance with federal securities laws, Commission regulations, and the association's own rules and regulations by imposing appropriate sanctions. When enforcing members' compliance with applicable

rules and regulations, the NASD must provide "a fair procedure for the disciplining of members and persons associated with members. . . . " 15 U.S.C. § 78o-3(b)(8); *Mister Discount Stockbrokers, Inc.*, 768 F.2d at 876.

The disciplinary process established by the NASD provides that the NASD Regional District Business Conduct Committee has original jurisdiction of all complaints regarding member violations and may conduct hearings, make findings and impose penalties. *Id.* In turn the final actions taken by the District Committee are subject to review by the NASD Board of Governors. Any final disciplinary sanctions imposed by the Board of Governors is subject to "full and independent review by the SEC as to the facts as well as the law." *Gold*, 48 F.3d at 990; 15 U.S.C. § 78s(d)(2). Because the SEC conducts *de novo* review of the NASD's sanctions, this court's consideration of alleged errors in the NASD proceedings is limited. We will "consider errors in [the NASD] proceedings 'only if and to the extent that they infected the Commission's action by leading to error on its part.' " *Schellenbach v. SEC*, 989 F.2d 907, 909 (7th Cir.1993); *accord Gold*, 48 F.3d at 990; *Mister Discount Stockbrokers, Inc.*, 768 F.2d at 877.

Our review of the proceedings before the SEC is not so limited. *Gold*, 48 F.3d at 990. This court may overturn an SEC sanctions order if it is unwarranted in law or without justification in fact. *Id.* (citing *Nowicki v. United States*, 536 F.2d 1171, 1178 (7th Cir.1976)). Nevertheless, our review of the SEC's findings of fact is highly deferential. Indeed, the SEC's findings of fact are conclusive if supported by substantial evidence. *Schellenbach*, 989 F.2d at 909. Further, we will reverse the Commission decisions concerning sanctions only if this court finds that the SEC

abused its discretion. *Id.*; *Mister Discount Stockbrokers, Inc.*, 768 F.2d at 879. With this limited scope of review in mind, we turn to Otto's arguments.

A. Fairness of NASD Proceedings

Otto initially argues that the NASD proceedings violated his due process rights urging three separate grounds: 1) the NASD admitted into the record Smith's unsworn hearsay statements; 2) the NASD did not provide him with an opportunity to cross-examine Smith; 3) a six-year delay between the time of the misconduct and the date of the hearing prejudiced him because he could not call favorable witnesses who had died. None of Otto's arguments has merit.

We note at the outset that Constitutional standards do not apply unless the NASD is a state actor. *See R.J. O'Brien & Assoc., Inc. v. Pipkin*, 64 F.3d 257, 262 (7th Cir.1995). The fact that the NASD is subject to "extensive and detailed" governmental regulation does not necessarily convert that organization's actions into those of the state. *See Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 350, 95 S.Ct. 449, 42 L.Ed.2d 477 (1974). Indeed, although we have not expressly ruled on the question of whether the NASD is a state actor, we have previously expressed doubt about "the proposition that the comprehensive regulation of securities exchanges by the federal government would turn those exchanges into government actors." *Gold*, 48 F.3d at 991 (suggesting that the New York Stock Exchange was not a state actor, but declining to rule on the merits of that issue because petitioner had waived the argument on appeal). In addition, several of our Sister

Circuits have reached the conclusion that the NASD is not a state actor. *See, e.g., Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir.1999) (noting that the NASD is a private corporation that receives no federal or state funding; that its creation was not mandated by statute; and that the government has no voice in the selection of its members); *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 699 n. 5 (3d Cir.1979). In any event we need not decide the issue of whether the NASD is a state actor in this case because Otto admitted all of the facts necessary to establish his guilt, which dooms his due process arguments.

At his hearing before the NASD Board of Governors, Otto admitted, among other things, that WBC was fictional, that Smith was the only investor, and that he used Smith's funds for his "personal stuff." Further, when Smith requested to withdraw her WBC funds in April 1994, Otto continued his deception and delayed returning her money. First, he explained to her that it could take a few weeks to find a replacement and urged her to instead remain in the club. Later, Otto sent her a letter blaming the nonexistent club for the delay in the return of her money. Ultimately, he continued his deception long enough to retain her money for six months after she initially requested it.

Despite his admissions, Otto nonetheless presses the argument that he somehow was prejudiced by Smith's absence at his hearings. The premise of Otto's argument

is that if he were allowed to cross-examine Smith[2] *she* would have confirmed his explanation that she used WBC to hide assets from her husband and that she had given him permission to use the funds for his personal and business expenses. Otto's argument, however, is nothing more than pure fancy. First, there was no evidence that Smith had any prejudice against Otto that might have undermined the credibility of her complaint. Second, the *facts* of her complaint were not contradicted by any direct testimony, and instead were largely *corroborated* by Otto's own admissions. Moreover, Smith's former husband did testify at the hearing and expressly rejected Otto's assertion that the parties were contemplating divorce or separation during the time Smith had invested in WBC. Finally, Otto's letters to Smith reveal the utter incredibility of his assertion that Smith was using WBC to hide assets from her husband – for if Smith had been aware that WBC did not exist (as Otto suggests she was) then what need was there to persist in blaming the delay in the return of her funds on the non-existent club? Otto's argument has no foundation in fact. Furthermore, even if it did, it is well established that hearsay evidence is admissible in administrative proceedings, if it is deemed relevant and material. *Keller v. Sullivan*, 928 F.2d 227, 230

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[2] In an attempt to secure Smith's presence, Otto's attorney sent to her a "subpoena." The document bears the indicia of the NASD (despite the fact that neither the NASD nor Otto himself had subpoena power) and "commands" her to appear with documents, falsely threatening her with punishment for contempt if she failed to comply. Otto's attempt to badger and even intimidate Smith into testifying only further undermines his claims and further suggests that he did not "observe high standards of commercial honor."

(7th Cir.1991) (citing *Richardson v. Perales*, 402 U.S. 389, 91 S.Ct. 1420, 28 L.Ed.2d 842 (1971)). In addition to its relevance, Smith's complaint was supported by several indicia of reliability – most notably the corroboration from Otto's admissions.

Otto also suggests that the delay in holding the hearing violated his due process rights because several witnesses, who would have testified that they participated in the WBC, died before the hearing was held. This claim is equally fanciful as Otto's claim that his due process rights were violated by his inability to cross-examine Smith. The testimony of these witnesses would have largely been irrelevant. Otto admitted that he used Smith's money for his business and personal expenses and whether other people had invested in the fictitious club he created is of no moment. Further, Otto admitted at the hearing that, besides himself, Smith was the only investor in WBC, thus directly contradicting the testimony he suggests he would have presented.

Given Otto's admissions coupled with the incriminating documentation he sent throughout her investment, Otto's claims that the proceedings were unfair and violated his due process rights must fail. Rule 2110 required Otto to "observe high standards of commercial honor and just and equitable principles of trade." Nothing in the record even remotely suggests that an error in the NASD proceedings infected the SEC's review. Consequently, our review is limited only to consideration of whether the SEC abused its discretion in holding that Otto violated Conduct Rule 2110. It did not. Otto's admissions and letters to Smith more than amply provide a basis to conclude that Otto did not "observe high standards of

commercial honor and just and equitable principles of trade."

B. Severity of Sanctions

Otto next argues that the sanctions imposed exceeded the recommended sanctions under the NASD's guidelines, and thus, were improperly imposed. Otto also suggests that the NASD and SEC did not weigh all of the factors referenced on the NASD's sanction guidelines in reaching their determinations that the sanctions imposed were warranted. The NASD outlines eight factors relevant to imposing sanctions: 1) prior or other similar misconduct; 2) attempts to conceal conversion, misappropriation, or misuse; 3) forgery of documentation or customer's signature; 4) duration of the period the securities or funds were converted; 5) essentially stealing versus mistaken belief of authority to use; 6) value of converted, misappropriated or misused funds or securities (loss to customer); 7) prompt and voluntary restitution, clear evidence that the funds or securities were returned to the customer; 8) other aggravating or mitigating factors. The sanction guidelines, however, are not rigid and mechanical and serve only as a starting point for determining the proper disciplinary action. *In the Matter of Steven D. Goodman*, 2001 WL 62607 at *5 (S.E.C. Jan. 26, 2001).

Otto comingled Smith's funds with his own for the sake of his own personal convenience and deprived her of the opportunity to invest those funds in a legitimate investment. Further, he concealed this use of funds from Smith. Although he did ultimately return the funds, he

put her funds at risk for more than two years. When Smith asked Otto to return her money, he continued to lie to her, attempted to convince her to leave her money invested in the fictitious WBC account, and only returned her money after six months. Given the ongoing deception in the face of a request for the return of her funds and Otto's refusal to accept responsibility for his misuse of Smith's funds, we agree with the SEC's decision to approve the NASD's imposition of sanctions.

The SEC's order is AFFIRMED.

APPENDIX B

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. ____

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 43296 / September 15, 2000

Admin. Proc. File No. 3-9938

In the Matter of
The Application of
KEVIN LEE OTTO 908 W. Oklahoma Milwaukee, Wisconsin 53215
For Review of Disciplinary Action Taken By The
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEDINGS

Violation of Rules of Fair Practice

Registered representative of a member firm of registered securities association deposited customer's funds in his personal bank account without the customer's knowledge or authorization and used the funds for his own personal benefit. *Held,* association's findings of violation and sanctions it imposed are *sustained.*

APPEARANCES.

James A. Bolt, for Kevin Lee Otto.

Vickie R. Olafson, for the National Association of Securities Dealers, Inc.

Appeal filed: July 20, 1999
Briefing Completed: October 25, 1999

I.

Kevin Lee Otto, during the period at issue, was a registered representative of members of the National Association of Securities Dealers, Inc. Otto was registered as a general securities representative with Hamilton Investments, Inc. from May 1991 through August 1992, with Wellington Investment Services Corporation from October 1992 to August 1993, and with First Montauk Securities Corporation from November 1993 to December 1996. The NASD found that Otto obtained $22,000 from customer Mary Sue Smith and used those funds for some purpose other than the benefit of the customer for over two years without the customer's knowledge or authorization, before returning the funds to her.[1] The NASD censured Otto, fined him $35,000, and barred him from association with any member firm in any capacity. We base our findings on an independent review of the record.

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[1] The NASD found that this conduct violated Rule 2110 of the NASD's Conduct Rules. Rule 2110 provides that "a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

II.

Smith maintained securities accounts at the various firms where Otto worked throughout the time period relevant to the complaint. Otto handled Smith's accounts. In early 1992, Otto solicited money from Smith to invest in an entity he described to her as the "Wisconsin Business Consortium" or "WBC." Otto told Smith that WBC was a group of investors that found special long-term investments with a rate of return equal to the Treasury Bill rate "plus a couple of percentage points."[2] Otto received $22,000 from Smith for investment in WBC at about the same time he gave her the February 1992 letter describing WBC.

Otto conceded at the hearing that no investment group by the name of WBC ever existed. He stated that he deposited Smith's funds into his personal bank account and a Charles Schwab account maintained in the

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[2] In a letter to Smith dated February 1992, Otto described the "investment group" as follows:

> WBC is a group of people that network and bring to the table business opportunities which enable us to make some cash. These are opportunities that you and I as individuals probably wouldn't see, i.e., industrial equipment that we purchase cheaper and sell, foreclosure of homes or buildings, business ventures and so on. Again as I stated on the phone this is not an investment nor is it offered by any securities company. It has nothing to do with me as a broker or my brokerage firm. This is a private thing. It is kind of fun. I think you'll like it.

names of Donna Lebrecht and a company called PowerSource Battery Corporation ("PowerSource").[3]

Otto said that he used Smith's funds for "whatever [he] had to for personal stuff." He also used Smith's funds for expenses related to the operations of PowerSource. Otto and LeBrech formed PowerSource in March 1991. It steadily lost money, and decided to file for bankruptcy in February 1992, the same month Otto solicited Smith's money. Otto never informed Smith that he used her funds to pay his personal and PowerSource's operating expenses.

Throughout the two-year period that Otto had Smith's funds, he sent her periodic portfolio update statements ("Portfolio Updates"). These updates referenced

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[3] Otto claimed that Smith asked him to hide the funds that she had given him to invest in WBC. According to Otto, Smith wanted to conceal them from her husband, because she was having problems in her second marriage and had lost a lot of money in a previous divorce. The record contains no evidence corroborating Otto's claim. In fact, Otto's claims are undercut by the testimony of Smith's former husband, who was married to Smith from June 1990 to June 1996. He testified that in early 1992 he had no contemplation of separation or divorce. He also stated that Smith was investing money with Otto she had received from her prior divorce, but that he did not know and never asked her the name or nature of any of her investments. Moreover, Otto's statement of where he deposited Smith's funds is not supported by the record. The account records Schwab produced show no activity in the LeBrech-PowerSource account after early September 1991. The responses received by the NASD from the two banks where Otto maintained personal accounts indicate that one account was not opened until summer 1993, and the second account had no available records prior to Spring 1993.

Smith's other investments with Otto and, under the designation "Tax-Free," also listed the amount she had given him for investment with WBC. In April 1994, Smith wanted some money from her "WBC account," and requested a payment. Although Otto disputed that Smith made the request, it is corroborated by a hand written letter from Otto to Smith, stating that the "investment club" had invested the money and that it could take "a few weeks to find a replacement" for Smith's position. The letter also stated that "[o]nce we sell your seat, we are out unless another opens up." Otto informed her that she could have approximately $3,000, but would have to leave a balance of $25,000 to stay in the "club."[4] However, it was not until June 1994 that Otto made a payment of $3,576.24 (later returned for insufficient funds) to Smith. The Portfolio Update dated June 30, 1994, stated that the "Tax-Free" account was "liquidated June, 1994."[5]

Smith indicated in a notation to a copy of Otto's April 1994 letter that, because it had taken so long (two months) for Otto to return the $3,576.24 portion of her funds, she decided to seek the return of the balance of her

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[4] Smith signed an acknowledgement dated May 13, 1994, in which she agreed to keep $25,000 on deposit.

[5] In a letter dated May 13, 1994, Otto advised Smith that the current value of her funds was $28,576.24. There is nothing in the record to show the source of this figure. As noted above, although Otto claims he deposited Smith's funds into his personal bank accounts and the Charles Schwab account maintained in the names of Donna LeBrecht and PowerSource, the record does not show this.

funds from the WBC investment. Apparently, she communicated this decision to Otto because, in another handwritten letter dated July 27, 1994, he again attempted to delay paying Smith by stating that he had not yet received the "exit papers for the investment club."[6] Otto stated this despite the fact that he had already sent Smith the June 24, 1994 Portfolio Update in which he described Smith's "investment" account as having been "liquidated." Otto eventually sent Smith a check for $26,346 on October 22, 1994. When questioned about the "liquidation" and the whereabout of Smith's money from July 1 to October 22, 1994, Otto testified that he did not know where her money was, and that he may have spent it.

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[6] This letter also demonstrates that Otto continued to deceive Smith as to the existence of the "investment group," his control over the funds, and their disposition:

> As your request is unusual things don't happen that fast. The group has assured me that the funds will not be less than its value at the time the funds were requested. . . . At the time I requested your distribution the funds were at $25,207.19. They were to be invested in (all group funds) in a private placement deal in an upcoming high tech area of computer technology. I believe it is too late to ask to stay in, besides for the recent requests which they view as (my fault) problems (requests and indecision of funds) they have booted me out of the club. . . . The group is not happy with me.
>
> This is an exclusive club with most people of professional investment background. I pushed to get us in, therefore I can't cause a lot of wave sic]. I should hope to receive our exit papers soon and subsequently the funds.

According to Otto's own testimony, everything in his letter is false.

The District Business Conduct Committee ("DBCC") determined that Otto had violated Rule 2110 of the NASD Conduct Rules because he obtained $22,000 from Smith and used those funds for some purpose other than Smith's benefit for over two years without Smith's knowledge or authorization. As a consequence, the DBCC barred him from association with any member in all capacities, and fined him $110,000. On June 28, 1999, the National Adjudicatory Council ("NAC") affirmed the DBCC's decision, but modified the fine amount to $35,000.[7]

III.

From the time he solicited Smith throughout the period he had Smith's money, Otto deceived his client with a network of lies. He represented to Smith that her funds had been invested in an "investment club" that, by

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[7] The NAC stated that, although the DBCC decision did not specify the Sanction Guideline that it used to calculate the $110,000 fine, it appeared from the staff's brief that the DBCC used the Guideline for conversion, which recommends a fine of five times the amount converted. The NAC noted that the complaint did not charge conversion, and the DBCC did not make a finding of conversion. The NAC found that Otto misused Smith's funds and that the Sanction Guideline for Improper Use of Funds or Securities was more analogous to this case. This Guideline recommends a range of $2,500 to $20,000. The NAC concluded that a fine above the recommended maximum was warranted in view of the facts of this case. The NAC particularly noted that Otto did not "mistakenly" believe that he had authority to use Smith's funds as he did, that he misrepresented his use to her, and that she had no knowledge of his use.

his own admission, did not exist. In 1994, when Smith sought to retrieve her funds, rather than informing her that he was using her money to fund PowerSource and "for personal stuff," Otto repeatedly delayed returning her money with statements such as: the "investment club has invested cash, [s]o it may take a few weeks to find a replacement for your position;" "[i]n order to keep your account active it is requested that you keep a minimum of $25,000 on deposit. . . . If you have any questions please contact your club representative;" and "I've not yet received our exit papers for the investment club." Such deception of a client about the use of money is unethical and reprehensible.

Otto claims that Smith knew what he was doing with her money and authorized him to use the funds as he did. This is patently false. Otto's own testimony and handwritten documents introduced at the hearing contradict this claim. All of the evidence indicates that Smith knew only that Otto was investing her money in WBC. On the basis of the facts described above, we find that Otto engaged in conduct that is inconsistent with high standards of commercial honor and just and equitable principles of trade.[8]

Otto raises various procedural and constitutional objections to the NASD proceedings; we find that they

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[8] *See e.g., John F. Legens*, 52 S.E.C. 606 (1996) (violation of just and equitable principles may be based merely on unethical conduct); *Thomas E. Jackson*, 45 S.E.C. 771, 772 (1975) (even wrongdoing not involving securities sufficient for finding violation of rules, because NASD could justifiably conclude that on another occasion it might involve securities.)

are without merit. First, Otto claims that the complaint does not give him adequate notice of the claims against him, as required by section 15A of the Securities Exchange Act of 1934.[9] Otto does not provide a substantive basis for his objections. He merely complaint that the complaint is only five paragraphs long, and that NASD Conduct Rule 2110 is vague.[10] The complaint references Otto's February 1992 memorandum to Smith describing a "private business opportunity" known as "Wisconsin Business Consortium." It then states that Smith provided Otto with $25,000, and that Otto informed Smith that her funds would be pooled with funds provided by other individuals and used by WBC for investment. The complaint further states that Otto did not invest in any "business opportunities" other than corporations or business entities which he operated or controlled, without her knowledge or authorization. The complaint states that Otto deposited Smith's funds in a bank account or bank accounts in which he had an interest or which he controlled, and used Smith's funds for some purpose other that her benefit. Finally, the complaint states that Otto's

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[9] 15 U.S.C. Section 78o-3. This section, in pertinent part, provides that the NASD is required to notify a respondent of, and give him an opportunity to be heard upon, the specific charges against, and grounds for denial of membership, bar, or prohibition or limitation under consideration and keep a record.

[10] We have previously stated that rule 2110 "is sufficiently specific and provides an adequate standard of compliance." *Stephen J. Gluckman*, Exchange Act Rel. No. 41628, 70 SEC Docket 418, 427 n. 30 (July 20, 1999), *citing Benjamin Werner*, 44 S.E.C. 622, 629 & n. 11 (1971), and *Vail v. S.E.C.*, 101 F.3d 37, 39 (5th Cir. 1996) (predecessor to Conduct Rule 2110 was not unconstitutionally vague).

acts, practices and conduct constitute violations of NASD Conduct Rule 2110. Thus, we believe that the complaint adequately notified Otto of the conduct and the NASD rule that were the subjects of the proceeding. We find the complaint and the ensuing hearing met the requirements of Section 15A of the Securities Exchange Act.

Otto also claims that he was denied due process because Smith did not testify at the hearing, and as a result, the NASD's entire case was based upon hearsay.[11] Specifically, Otto cites the case of *Gibbs v. SEC*, 25 F.3d 1056 (10th Cir. 1994) for the proposition that, in the NASD hearing process, a respondent must be allowed to cross examine prosecution witnesses. *Gibbs* is not relevant here. In *Gibbs*, resolution of the case turned on the telephonic testimony of the complaining witness, which was disputed by the respondent. The court ruled that it was proper for the hearing panel to make a credibility determination on the basis of telephonic testimony. Here, there is no such dispute to be resolved because Otto admits all of the facts necessary to determine his guilt. Specifically, he admits that he: (a) recommended investment in a fictitious "investment group," (b) received money from Smith for investment in the "investment group," (c) continually represented to Smith over a two year period that

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[11] The NASD, as a private corporation, is not subject to the due process requirements of the Constitution. *Datck Securities Corp.*, 875 F. Supp. 230, 233-34 (S.D.N.Y. 1995). Nonetheless, in applying Section 19(e)(1)(A) of the Exchange act, 15 U.S.C. Section 78s(e)(1)(A), which governs our review of disciplinary actions taken by SROs, we have indicated that a fundamental principle governing all SRO disciplinary proceedings is fairness. *See U.S. Associates, Inc.*, 51 S.E.C. 805, 810 (1993).

her funds were invested in the "investment group," and (d) used Smith's funds for his personal use. Thus, the NASD's case is not based entirely on hearsay.

Further, Otto's objections to the inclusion of hearsay statements by Smith are inapposite. The Commission has held repeatedly that hearsay is admissible in administrative proceedings and, in appropriate circumstances, may even constitute the sole basis for findings of fact.[12] We evaluate hearsay for its probative value, reliability, and the fairness of its use. The factors to consider include the possible bias of the declarant, the type of hearsay at issue, whether the statements are signed and sworn to rather than anonymous, oral, or unsworn, whether the statements are contradicted by direct testimony, whether the declarant was unavailable to testify, and whether the hearsay is corroborated.[13]

The written statements provided by Smith meet a number of these criteria. Although Smith's statements are not sworn, they are written, signed, and confirmed and corroborated by Otto's own testimony and documents. Since Otto eventually returned Smith's money, plus an amount of interest, she had little incentive to give a false statement.[14] As to Smith's availability as a witness, the

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[12] *See, e.g., Harry Gliksman*, Exchange Act Rel. No. 42255, 71 SEC Docket 892,901 (December 20, 1999), and cases cited therein. The hearsay statements of Smith are not, of course, the sole basis for our findings of fact here.

[13] *Charles D. Tom*, 50 S.E.C. 1142, 1145 (1992).

[14] Otto's testimony provides direct and independent evidence that he used Smith's money for his own personal use and never informed Smith that he did so. Further, his

NASD cannot compel a customer such as Smith to appear at a hearing before it.[15] Thus, we see no barrier to relying on Smith's statements as probative evidence.

Otto further claims that he was prejudiced by a delay in the filing of the complaint and the setting of the matter for hearing because of the death of two key witnesses and the memory failure of another witness. He claims that the two deceased witnesses, plus two other persons, were also investors in WBC, along with Smith and LeBrecht.

This claim is frivolous. Otto conceded that WBC did not exist. LeBrecht denied being an investor in WBC. Otto made no excuse for his failure to obtain evidence from the two purported investors who were still alive. He made no showing of what relevant evidence the two "key" witnesses might have provided.

Moreover, during an earlier Wisconsin state investigation based on the same misconduct, Otto did not mention these "key" witnesses,[16] although they were alive

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handwritten and other contemporaneous documents show that he continually referred to Smith's participation in an "investment club" that did not exist.

[15] *Id.* In *Tom*, the customer was not available because "[he] was reluctant to have any type of confrontation with Mr. Tom."

[16] Smith sent a letter of complaint to the state of Wisconsin dated October 26, 1994. The Office of the Commissioner of Securities for the State of Wisconsin began an investigation on October 31, 1994, which culminated in a consent order issued May 26, 1995. The consent order suspended Otto's agent's license for six months.

when the Wisconsin case concluded[17] and Otto stated in his brief that "all relevant witnesses were interviewed" and "all relevant documents were produced."[18] Finally, Otto's claim of prejudice is further compromised by the fact that it was his own failure to produce documents for almost two years, despite repeated requests and visits from NASD representatives, that caused much of the delay.[19] We find that Otto's claim of prejudicial delay is without merit.

Otto contends that the decision to impose a permanent bar is overly severe. Exchange Act Section 19(e) governs our review of sanctions imposed by a self-regulatory organization. That provision requires that we sustain the sanctions imposed, unless we find they are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition.

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[17] Otto stated that these "key" witnesses died in late 1996 and February 1998 respectively.

[18] Appellant's Brief at 20.

[19] the NASD sent Otto detailed requests for documents on December 20, 1994 and September 28, 1995, to which Otto provided incomplete responses. In the September 28, 1995 letter, a NASD special investigator, Mark Tomlin, volunteered to come to Otto's office after Otto confirmed that he had the information there. Tomlin testified that he arranged with Otto to visit Otto's office, and that he went there at the scheduled time and date. Tomlin testified that, after he arrived, Otto said that he did not have any of the records, but that he (Otto) thought his attorney might have them. When Tomlin contacted the attorney, the attorney informed him that he was not aware of any of the records. It was not until near the end of October 1996 that Otto provided all the requested information.

It is undisputed that Otto co-mingled his and Smith's funds for the sake of his own personal convenience and use, and deprived her of the opportunity to invest those funds in a legitimate investment. It is also undisputed that he concealed his use of the funds from Smith, and delayed returning Smith's funds for at least four months. Through his mishandling of these funds, Otto put Smith's funds at risk for over two years. Otto has refused to accept responsibility for his action. He does not appear to recognize the wrongful nature of his conduct.[20] Otto's refusal to acknowledge his misconduct and actions demonstrate a serious misunderstanding of the obligations he owes to a customer as a registered representative. His actions make us doubt his commitment to the high standards demanded by the securities industry. Under the circumstances, we do not find that either the bar or the $35,000 fine were excessive, oppressive or an undue burden on competition.[21]

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[20] Otto's testimony indicates his lack of awareness that his conduct was wrongful. He contends that Smith did not file her complaint because she was unhappy with his services, but because she wanted to support her father's separate complaint against him. Smith's father's case is irrelevant to this case. Otto's attempt to deflect the focus from his actions shows his continued refusal to accept any blame, and ignores the fact that the main reason Smith may not have expressed unhappiness is because he repeatedly concealed from her his use of her funds.

[21] The monetary sanctions imposed on Otto is above the range recommended by the NASD Guideline for improper use of funds not amounting to conversion or misappropriation. However, in this case, Otto's deception and concealment are sufficient aggravating factors to warrant an amount exceeding the recommended maximum. Similarly, although the Guideline does not specifically provide for a bar for improper use of

An appropriate order will issue.[22]

By the Commission (Chairman LEVITT and Commissioners HUNT, CAREY and UNGER).

/s/ Jonathan G. Katz
Jonathan G. Katz
Secretary

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funds, the Commission agrees with the NASD that a bar is essential based on the egregious nature of Otto's deception, misconduct, and his continued lack of understanding of his responsibilities as a registered broker.

[22] We have considered all of the contentions advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

APPENDIX C

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 43296 / September 15, 2000

Admin. Proc. File No. 3-9938

In the Matter of
The Application of
KEVIN LEE OTTO 908 W. Oklahoma Milwaukee, Wisconsin 53215
For Review of Disciplinary Action Taken By The
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES ASSOCIATION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken by the National Association of Securities Dealers, Inc. against

Kevin Lee Otto, and the Association's assessment of costs, be, and they hereby are, sustained.

By the Commission.

/s/ Jonathan G. Katz
Jonathan G. Katz
Secretary

APPENDIX D

15 U.S.C. § 78o-3(h)

(h) Discipline of registered securities association members and persons associated with members; summary proceedings.

(1) In any proceeding by a registered securities association to determine whether a member or person associated with a member should be disciplined (other than a summary proceeding pursuant to paragraph (3) of this subsection) the association shall bring specific charges, notify such member or person of, and give him an opportunity to defend against, such charges, and keep a record. A determination by the association to impose a disciplinary sanction shall be supported by a statement setting forth –

(A) any act or practice in which such member or person associated with a member has been found to have engaged, or which such member or person has been found to have omitted;

(B) the specific provision of this title, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or the rules of the association which any such act or practice, or omission to act, is deemed to violate; and

(C) the sanction imposed and the reason therefor.

(2) In any proceeding by a registered securities association to determine whether a person shall be denied membership, barred from becoming associated with a member, or prohibited or limited with respect to access to services offered by the association or a member

thereof (other than a summary proceeding pursuant to paragraph (3) of this subsection), the association shall notify such person of and give him an opportunity to be heard upon, the specific grounds for denial, bar, or prohibition or limitation under consideration and keep a record. A determination by the association to deny membership, bar a person from becoming associated with a member, or prohibit or limit a person with respect to access to services offered by the association or a member thereof shall be supported by a statement setting forth the specific grounds on which the denial, bar, or prohibition or limitation is based.

(3) A registered securities association may summarily (A) suspend a member or person associated with a member who has been and is expelled or suspended from any self-regulatory organization or barred or suspended from being associated with a member of any self-regulatory organization, (B) suspend a member who is in such financial or operating difficulty that the association determines and so notifies the Commission that the member cannot be permitted to continue to do business as a member with safety to investors, creditors, other members, or the association, or (C) limit or prohibit any person with respect to access to services offered by the association if subparagraph (A) or (B) of this paragraph is applicable to such person or, in the case of a person who is not a member, if the association determines that such person does not meet the qualification requirements or other prerequisites for such access and such person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the association. Any person aggrieved by any such summary action shall

be promptly afforded an opportunity for a hearing by the association in accordance with the provisions of paragraph (1) or (2) of this subsection. The Commission, by order, may stay any such summary action on its own motion or upon application by any person aggrieved thereby, if the Commission determines summarily or after notice and opportunity for hearing (which hearing may consist solely of the submission of affidavits or presentation of oral arguments) that such stay is consistent with the public interest and the protection of investors.